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# GUIDELINES FOR THE EVALUATION OF CONTRACTUAL ARRANGEMENTS IN THE FAST FOOD SECTOR IN DEVELOPING COUNTRIES *

Prepared by

J. Cieslik **
UNIDO Consultant

[redacted]

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** Senior Adviser, Foreign Trade Data Centre, Warsaw, Poland.

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INTRODUCTION

After the Second World War, a rapid expansion of fast food chains took place in developed market economy countries. In the 1960s the internationalization of major restaurant chain operations began, mostly in developed market economy countries. On the other hand, the growing urban populations of developing countries has resulted in an increased demand for fast food restaurant services beyond the scope of that which could be satisfied by traditional small-scale operations. As a result, the expansion of the activities of large transnational fast food chains began in these countries in the late 1960s and in the 1970s.

The foreign-associated fast food outlets were mainly established in selected Latin American and South-East Asian countries, but the current expansion programmes of major transnational restaurant chains indicate that the number of outlets in developing countries may increase substantially in the near future.

Consequently, government agencies responsible for the formulation and implementation of development policies have been confronted with various aspects of the fast food chain operations. Such institutions included, inter alia, those approving contractual arrangements entered into by local companies with foreign partners. As a result, those government bodies dealing with the evaluation and registration of such arrangements [1/] and participating in UNIDO's cooperative scheme called Technological Information Exchange System (TIES), requested the UNIDO Secretariat to undertake a study and prepare guidelines for the handling and evaluation of contracts used in the fast food sector.[2/]

While complying with the above recommendation, the UNIDO Secretariat commissioned a preliminary study on the subject which was completed in 1983.[3/] The study covered an analysis of the overall trends and major policy options with regard to the scope and forms of foreign participation in the fast food sector in developing countries. It also contained an empirical analysis of the major provisions based on a sample of five agreements provided by technology transfer registries from selected developing countries. The study had been discussed during the Eighth TIES Meeting of Heads of Transfer of Technology Registries at Caracas, Venezuela in 1983, which formulated the suggestions and recommendations as to the future course of action in that area.

The present report has to be viewed as a follow-up to the previous study. Unlike the former one, it deals exclusively with the contractual aspects of the administration and management of chain restaurants in developing countries. The empirical background was broadened and altogether eight contracts, plus selected data on five additional ones were taken into consideration. An analysis of the substantive provisions was carried out with a view to providing assistance to the staff of government institutions dealing with the approval and monitoring of such contracts. Consequently, only selected aspects of contractual arrangements were taken into consideration, i.e. those which may, directly or indirectly, affect the national interest represented by the government authorities. Thus, the present study should not be viewed as a manual for drafting and/or negotiating contracts for launching chain restaurants in developing countries. It should also be made clear that the approach adopted in the present study is biased, as the respective provisions are evaluated and recommendations made with a view to

protecting the interests of the recipient country and to some extent the local partner becoming a party to the contract.

Access to the contents of contracts currently negotiated or under implementation had a substantial effect on the scope and final results of the study. Firstly, it helped identify major trends and methods for defining various problems in the contracts, while taking into account the distinct features of the fast food sector. As a result it was possible to formulate pragmatic recommendations with due consideration to the traditions, standards and patterns prevailing in the fast food sector. Secondly, the areas where the interests of the recipient country were unsatisfactorily protected have been identified and these guidelines concentrate on those areas. Last but not least, examples of clauses which adequately safeguarded the interests of the recipient country were also found in the contracts surveyed. These are often quoted in the guidelines as being useful reference material.

The study consists of five chapters. The first chapter contains a systematic overview of contractual arrangements, with an attempt at providing a conceptual framework for the classification of contracts used in the fast food sector and identifying major problems in that area. In the second chapter an analysis of contract provisions defining the services offered by the foreign partner is given. The question of control of restaurant operations by a foreign partner with special emphasis on restrictive clauses is covered in Chapter III. Chapter IV deals with the most essential issue, i.e. payments to the foreign partner. Finally in Chapter V provisions relating to the contract duration and extension are discussed.

## I. CONTRACTUAL ARRANGEMENTS USED IN THE FAST FOOD SECTOR - AN OVERVIEW

### A. The role of contractual arrangements in the fast food sector

The fast food business represents a rare example of an industry where a nationwide as well as international expansion of the leading chains has been achieved through non-equity (franchise) arrangements with independent restaurant operators rather than through establishing wholly-owned outlets. In fact almost all leading fast food chains predominantly use franchises, although the largest and/or most profitable outlets in the home country are generally controlled directly by the parent company. With respect to the international expansion, especially in developing countries, this is accomplished through franchise contracts which, in some cases, can be accompanied by the foreign equity participation (majority or minority).

### B. The franchise agreement

The essence of a franchise agreement is the authorization of the franchisee by the franchisor to engage in business in a manner associated with and identified by a trade name. Although there is no uniform definition of franchise, the one given below seems to cover all essential aspects of such a contractual arrangement:

"Franchise means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

(a) a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing-plan or system prescribed in substantial part by a franchisor; and

(b) the operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating or its affiliate ; and

(c) the franchisee is required to pay directly or indirectly, a franchise fee."4/

Two major types of franchises may be distinguished: "product distribution franchising" and "business format franchising". The franchise arrangements used in the fast food industry belong to the second category. The "business format" or "entire system" category "describes the system used by a company (franchisor) which grants to others (franchisees) the right and license (franchise) to market a product and engage in a business developed by it under the franchisor's trade names, trademarks, service marks, know-how and method of doing business. In addition, the franchisor may sell the products and sell or lease the equipment and /or the premises necessary to the operation, or designate, or approve sources therefore. This in essence is a licensing of trademarks and the granting of a "bundle of rights": the franchising of entire business systems (such as those for restaurants, fast food establishments, convenience stores, motels, laundries, dry cleaning shops, automobile repair shops, etc)".5/

According to the above quoted definitions, the concept of the license and franchise are closely interrelated, although the franchise agreement covers a broader relationship between partners as compared to trademark and/or know-how licences.6/

Two types of franchises can be distinguished. Unit franchises are single retail outlets owned and operated by individual enterpreneurs. In contrast, an area franchise provides the franchisee with control of a geographic region with the right to establish unit franchises and sell additional unit franchises within the region to individual enterpreneurs. In international franchising area franchises are the more common. However in practical terms a distinction has to be made between the area covering the whole territory of a given country and the franchise granted by the foreign partner to the local companies covering a specified region.

C. The modalities of existing relationships in international fast food chain operations

In order to adopt a systematic approach to the contractual arrangements used in the fast food sector it is necessary to identify major categories of partners who enter into such arrangements. One may distinguish two principal levels of chain operations: The upper level, i.e. the parent company operating the system on a worldwide basis and the grass root level, i.e. the restaurant operator. We shall however include the intermediate levels, i.e. companies granted area franchise covering the whole country or a given region only. Such companies may operate their own outlets and/or grant sub-franchises to independent restaurant operators. The alternative arrangements and relationships most often found in the fast food sector are demonstrated in figure 1. It is worthwhile noting that only some contracts are formally concluded with foreign partners, thereby subject to the registration procedure. During the course of a preliminary investigation of contracts submitted for registration, special attention should be given to partners and their function within a chain, i.e. chain headquarters, intermediate level restaurant operators. Secondly, the identification of existing equity linkages between partners should be regarded as a crucial aspect of contract evaluation.

The question of standardization of contracts used in the fast food sector and their clauses deserves special attention. It should be borne in mind that the idea of unification and standardization represents the principal concept of chain operations and this affects contractual arrangements as well. The largest chains operate several thousands of outlets and with such a broad scope of activity standardization of contracts is becoming indispensable. Often reference is made to the standard or master franchise agreement used by a well-known international chain.

An analysis of sample contracts concluded by large transnational chains confirmed in principle the uniformity of contract formats. At the same time the principal conditions including payments offered by the same chain to their partners in various countries, differed substantially. Quite often additional provisions safeguarding the interests of the local partner were added to the standard format. The following remarks may lead to the conclusion that, with due respect to the unification of contractual arrangements in the fast food industry, there is also a substantial degree of flexibility in allowing for the effective negotiation and modification of the standard formats in order to protect the interests of local partners as well as the recipient country.

D. Suggested approach by Registries

In view of the rapid expansion of transnational fast food chains in developing countries and taking into account the economic, financial and socio-cultural implications of such operations conducted under franchise agreements, it is recommended that franchise contracts become the subject of scrutiny by the technology transfer registries in developing countries.

In those countries where the legal framework for registration of franchise agreements has already been established, it is necessary to solve some principal questions prior to opening the registration procedure. The first question is linked to the geographic coverage of the franchise granted by the foreign partner. Since direct unit franchises are extremely rare in international operations, the real alternative lies between regional or country-wide franchises. Regional franchises offer a greater opportunity for direct contacts by the local restaurant operators with the foreign partner as well as stimulate competition. This may not necessarily ensure an effective flow of knowledge and skills due to geographic distance and the lack of adequate efforts on the part of the franchisor, who usually operates hundreds or even thousands of such outlets in various countries. It seems that except for a few developing countries with the largest population others prefer country-wide franchises where the chain activities are coordinated by one strong organization (franchisee) offering various services, including training, to the local restaurant operators. The advantage of the latter arrangement is that the conditions for operation of a given chain in the recipient country are settled in one agreement.

The second strategic question is linked to foreign equity participation. Although the attitudes of developing countries towards direct foreign investment vary substantially, it may be argued that restaurant services have traditionally been recognized as an area for expansion of local businesses. Foreign investment in this sector should not be encouraged. A somewhat different approach may be adopted to equity participation in cases where the company franchisee operates the system country-wide. Bearing in mind that such companies usually coordinate training and technical assistance programmes for individual outlets, some equity participation could contribute to a stronger involvement by the foreign partner in providing such services.

## II. SERVICES AND BENEFITS OFFERED BY THE FRANCHISOR

### A. Introductory remarks

An analysis of the contractual provisions defining the scope of services and benefits offered by the foreign partner should be carried out by the Registry with three major objectives in mind. Firstly, the contract must ensure the effective conditions for transfer of technology, skills and expertise to the local fast food sector as well as to the suppliers of raw materials, supplies, equipment etc. Secondly, the identification of services and benefits offered by the franchisor should assist in defining whether the contract resembles a typical trademark licence or a composite licensing agreement. The latter question is essential in view of the rigid approach adopted by many Registries with respect to pure trademark licenses. Finally, the services and benefits are usually weighted against payments involved in a given agreement and therefore serve as an indispensable element for payment evaluation. This will be discussed in Chapter IV.

B. Transmission of property rights

A typical franchise contract in the fast food sector stipulates directly or indirectly, the granting of the following property rights to the franchisee:7/

- use of trademarks, trade names and patents of the franchisor;
- use of brand image and design and decor of premises developed by the franchisor in projecting that image;
- use of franchisor's secret methods;
- use of recipes, formula, specifications and processes, and methods of manufacture developed by the franchisor.

In order to avoid future conflicts the granting of the above rights should be clearly defined in the contract. Unfortunately this is not standard practice in leading fast food chains. The agreements surveyed usually emphasized only one element of the "property package", i.e. the right to use trademarks, whereas other elements were expressed as strict obligations imposed upon the franchisee, (e.g. an obligation to comply with the standard methods of operation).

Since the transmission of property rights is the key element of a franchise agreement,the Registries should insist on a clear definition of all rights granted to the franchisee.

The question of exclusivity in franchise agreements require further clarification. The empirical survey revealed various approaches adopted in the area of regional and country-wide franchises:

- exclusive licence was granted for a given territory;
- first priority was given to the franchisee providing he/or she complied with the expansion programme included in the contract. The failure on the part of the franchisee gave the franchisor the right to automatically grant franchises to someone else;

- the franchise was clearly stipulated as non-exclusive.

It is suggested that Registries consider the question of exclusivity, with due attention to the overall development programme of the fast food sector. Based on this, the Registries may come to the conclusion that one local partner can sufficiently coordinate the activities of an international chain in a given country, thus favouring an exclusive arrangement or stimulate fierce competition in that sector, which can be achieved by non-exclusive arrangements.

The question of sub-licensing rights should be resolved in a similar way. In principle a Registry should favour explicit clauses granting sub-franchising rights to the franchisee. In the latter case, a further expansion of the chain operations will be covered by subsequent agreements among local partners. The clauses limiting the franchise coverage to outlets directly controlled by the franchisee should be deemed restrictive as the expansion of chain operations may not necessarily be accomplished through equity

arrangements. On the other hand, the standard requirement calling for the approval of each sub-franchise by the franchisor seems to be justified in view of trends and traditions in the fast food business.

C. Training of local personnel

In the area of training of local personnel a considerable common interest exists between the franchisee and the franchisor. For the former this becomes the most effective way of assimilating unique methods, organization and management techniques of the fast food restaurants. The franchisor, on the other hand, can achieve worldwide unification and high levels of operational standards. For that purpose, the leading international fast food chains have established special training facilities which carry out various training programmes for restaurant personnel in the parent country as well as abroad.

An analysis of the respective contract provisions showed that the formulation of the rights and obligations of partners left much to be desired. Some contracts did not specify the training services at all. Others contained extensive lists of courses offered at the international training centre without adequate specification of the conditions for using such services. Another questionable aspect is the obligatory character of training. In some contracts the respective formulations clearly stipulated that prior to assuming managerial responsibilities, the key personnel of the franchisee should undergo specialized training offered by the franchisor. The payment conditions were not adequately defined either (this will be discussed in Chapter IV).

During the course of contract evaluation the Registries should carefully screen the provisions relating to training in order to make sure that at least the basic problems are adequately covered, i.e.:

- description of services to be provided by the franchisor;
- clear expression of the obligatory versus voluntary character of such services (in line with comments made in Chapter III);
- detailed specification of the financial problems associated with training in line with recommendations made in Chapter IV.

The above comments are mainly concerned with training carried out abroad. In view of the distance and costs involved it is obvious that only a limited number of the franchisee's personnel can take advantage of the franchisor's training programmes and facilities. The effective transmission of knowledge and experience might be further accelerated by introducing additional training in the recipient country.

An interesting clause on the establishment of training facilities in the host country with the assistance of the franchisor was found in one contract: "An educational installation will be created in the host country for the future training and education of the franchisee's employees and managers. The programme will be developed with the help of the faculty and will be taught by personnel employed by the franchisee and specially trained by the franchisor. It is hoped to construct and commission

this facility as soon as possible after the franchisee has opened his initial restaurants and in it will be trained the greater part of the personnel required to provide the system restaurants in the host country with personnel".

In those countries where the expansion programme stipulated the opening of a substantial number of fast food restaurants of a given chain (e.g. 10-20 within ten years), the Registry may recommend the establishment of a local training centre. The eventual extension of the initial agreement could be linked to the progress achieved in that area.

D. Transmission of secret formula and recipes

The secret formula and recipes constituting the essence of know-how possessed by a given chain are usually contained in the operating manual transmitted to the franchisee upon signature of the contract. The franchisee is obliged to strictly follow the rules for operating the restaurant and preparing the meals in accordance with the recipes developed by the franchisor. Since such formula and recipes are the major source of competitive advantage of the whole chain, the franchisor attempts to prohibit leakages of such proprietary technology to unauthorized users by inclusion of secrecy provisions which often extend beyond the time span of the contract. Additional protective measures against the potential leakage of secret information include the limiting of the number of operating manuals provided to the franchisee, and the requirement of additional payment for extra copies etc. Unfortunately such methods, directly or indirectly, hinder the effective transfer of technology as this limits the number of the franchisee's personnel who may have direct access to the proprietary know-how. The Registry should therefore insist that a sufficient number of copies of the operating manual be provided free of charge. It should be borne in mind that the franchisee cannot simply duplicate the manual as this would violate the copyrights of the franchisor.

E. Additional technical assistance services

In addition to training and handing over of the confidential operating manual discussed above, additional technical services are rendered by the franchisor prior to opening and in the course of operation of an outlet. These include, inter alia, assistance in the selection of suitable premises for the fast food outlet; advice in design, construction or remodelling; communication of new developments, techniques and improvements in the preparation of foods; and assistance in the area of management, marketing, accounting, transmission of research results, advertising material, etc.

Two approaches could be adopted in respect of additional technical services. The first relies on the assumption that this is an additional benefit for the franchisee, subject to separate remuneration or at least reimbursement of cost incurred. Alternatively, such services could be regarded as an inherent part of the operation of the whole chain. It is obvious that in order

to make sure that the outlet location and design conform with uniform standards, the staff of the franchisor has to check the premises and provide the franchisee with relevant documentation, specifications, advertising materials, etc.

It is recommended that the Registry ought, in principle, to follow the second approach. Thus, the general type contract provisions could be acceptable if no additional remuneration is involved. If, for some reason, the Registry has to approve some sort of remuneration, it shall insist on a detailed description of the scope of such services in the contract.

## III. CONTROL OF THE FRANCHISEE'S OPERATIONS

### A. Introductory comments

One of the main objectives of registering technology transfer contracts is to eliminate restrictive provisions which allow, inter alia, excessive control of the franchisee's operations by the foreign partner. The laws and regulations governing technology transfer recently introduced in a number of developing countries contain lists of clauses which are considered to be restrictive and have been eliminated during the course of contract evaluation. A major question which arises in this respect is the applicability of the standard measures used for the registration of technology transfer agreements to the fast food chain operations. It may be argued that the specific features of the fast food chain industry call for a flexible approach by the Registries to that issue. As a rule, the extensive uniformity and standardization of all aspects of business activities was the fundamental principle behind the fast food chain operations. In view of this, the Registries ought to maintain a flexible attitude towards certain provisions which are of a restrictive character but are predominantly aimed at safeguarding uniformity and a high level of standard of fast food services. At the same time the Registry should insist on eliminating those provisions which lead to excessive controls of the outlet operations by the franchisor. The areas calling for the Registry's special attention are as follows:

### B. Control of key managerial personnel

In principle the franchisors do not interfere directly in the selection of outlet managers. An indirect control found in one contract was achieved by the obligation to complete a specialized training programme at the franchisor's "university" prior to assuming managerial responsibility. In practical terms this requirement seemed justified as this was the only way of acquiring chain-specific knowledge. However, the Registry may recommend the modification of such respective provisions so that it is expressed as a general requirement, but not as a restrictive obligation.

### C. Tie-in provisions

The question of tied purchases calls for special attention on the part of the Registry. This is because the value of tied purchases could exceed by a large margin the remittances of

franchise fees and royalties. Obviously the franchisor is keenly interested in the use of food supplies, ingredients, equipment, etc. which are supplied by well-known approved suppliers from the home country by all foreign franchisees. This contributes to a greater worldwide uniformity and higher quality of services rendered. On the other hand the franchisor may achieve additional benefits from such purchases through equity or non-equity relationships with the suppliers. The local partner is also interested in the acquisition of necessary supplies, equipment and ingredients from abroad especially during the initial period of the opening of the restaurant, when local suppliers cannot be fully relied upon.

The Registry representing the national interest should consequently aim at eliminating all tie-in provisions, but with due respect to the uniform standards. A positive example of a Registry's intervention was found in one contract. The relevant clause suggested by the foreign partner read as follows:

> "Operator agrees to purchase from approved suppliers all food supplies, ingredients and equipment .... in precise conformity with the company standards."

Prior to registration the Registry requested the amendment of the above quoted clause so that the words: "from approved suppliers" were omitted. The new formulation leaves the question of supplier to the discretion of the franchisee provided the franchisor's standards are met.

A somewhat different approach may be adopted as regards the specific spice blends which are prepared according to the secret recipes and represent the essence of the franchisor's know-how. These blends are usually manufactured by the franchisor, who strictly controls their production and distribution. With respect to secret spice blends the typical tie-in clause reads as follows:

"Franchisee agrees to use only the franchisor's secret spice blends in the preparation of products designed by the franchisor and to buy from the franchisor, or, at the franchisor's option, a source designated by the franchisor, its full requirement of the franchisor's spice blends".

Consequently the Registry mentioned earlier introduced an alternative formulation to that clause:

> "Franchisee agrees to use only the franchisor's approved spice blends in the preparation of products designed by the franchisor and to purchase the ingredients required for such spice blends strictly in accordance with the franchisor's quality standards".

It should be made clear however that the elimination of tie-in provisions merely represents the first step towards decreasing the import dependency of the chain food restaurant services. Effective results in that area can be achieved once backward linkages, i.e. local suppliers of raw materials, ingredients, equipment, etc. are strong enough to meet quality standards, pricing, delivery

schedules, etc. The Registry may therefore recommend the broadening of the expansion programme outlined in the contract to cover technical services offered to local suppliers. Furthermore, the Registry may consider the effects achieved in the above mentioned field once the request for contract extension is submitted.

D. Non-competition and secrecy requirements

The franchisor is normally interested in the franchisee's engaging his full attention to running chain outlets, and therefore the provisions prohibiting the franchisee engaging in similar business practices were found in practically all contracts. Similarly, the clauses defining secrecy provisions are typical for

franchise agreements in the fast food sector. Taking into account the specific features of the chain restaurant business, such requirements seem justified. However the Registry should object to the extension of such requirements beyond the terms of the contract, as was found in several cases.

IV. REMUNERATION TO THE FOREIGN PARTNER

A. Introductory remarks

The remuneration to the foreign partner constitutes the most difficult problem in the process of contract evaluation. As a rule the position of the franchisee during the negotiation phase is rather weak, as the franchisor will aim at applying standard rates and levels of fees charged in the home country, which are relatively high. Thus the Registry's intervention will play a decisive role in lowering the total value of payments to the franchisor. It has been established without a doubt that the leading transnational fast food chains accepted fee levels in a number of developing countries which were substantially lower than those applied in the home country and other developed market economy countries. This could be used as a strong argument in the course of contract negotiation and registration.

Another argument for lowering fee levels can be drawn from the fact that the fast food restaurants are generally run by small enterpreneurs with limited financial resources. Thus the high fees paid to the franchisor, especially during the initial period, may hamper their growth potential.

In the fast food industry a substantial degree of uniformity was found as to the forms of remuneration to the foreign partner. Basically the combination of initial fee and royalty was applied. Additional financial transfers made by the franchisee to the franchisor include the remuneration for technical services and a contribution to the advertising programme.

B. Initial fee and remuneration for pre-opening expenses

An initial fee is usually paid prior to the opening of each

outlet. In the sample of contracts surveyed this fee ranged between US$5,000 and US$30,000. As a rule higher fees were charged for the newly constructed outlets compared to those which are adapted to the chain system.

The principal question which has to be resolved first is the justification for payment of the initial fee. Originally, it was meant as a reimbursement for the initial costs incurred by the franchisor prior to opening the outlet (mostly costs for field visits of the franchisor's personnel assisting in the site selection, construction, decoration, etc.). Such justification was stipulated in a straight-forward way in one contract:

> "The franchisee recognizes that the franchisor will incur substantial direct expenses in connection with the initial development and pre-inaugural support services and agrees to reimburse the franchisor for those direct expenses up to an amount of US$ X per each chain restaurant".

Although in most cases no justification was given for the payment of the initial fee this approach should be followed by the Registries while evaluating the level of the initial fee stipulated in the contract. Consequently, the scope of pre-opening services

ought to be used as a major yardstick in determining the level of the initial fee. In view of the above the Registry should consider the following options:

- accepting the flat initial fee, but at the lowest possible level;
- replacing the flat fee by the cost reimbursement formula, e.g.:

> "The franchisee agrees to pay to the franchisor the out-of-pocket expenses in providing marketing and technical services to the franchisor during the period necessary to establish the first six restaurants hereunder, including, without limitation, the travel and on-site living expenses of the franchisor's personnel as well as any architectural, engineering, accounting, advertising or other expenses incurred by the franchisor in connection with rendering such services".

The flat fee formula is more convenient for both partners and if a reasonable level is stipulated in the contract (e.g. in the range of US$5,000), it could be accepted by the Registry.

The recommended approach to the initial fee question in franchise agreements has an additional essential implication, namely the simultaneous payment of the initial fee and reimbursement of cost of pre-opening assistance should be rejected as this would mean repetitive charging for the same services. Such a situation has been identified in one contract and the Registry took proper action by eliminating the clause on the payment of the initial fee.

## C. Royalty level

### 1. Principal factors affecting the royalty rate

In order to define the acceptable level of royalty, the Registry should establish a general policy regarding chain franchise agreements in the fast food sector. The following alternative approaches were identified:

- chain franchise agreements were treated in a similar way as pure trademark licenses, which are generally discouraged by Registries, inter alia, through defining an upper ceiling for the royalty rate at the level of 0.5 to 1.0 per cent of gross sales.

- chain franchise agreements are viewed in a similar manner to composite licensing agreements covering technical assistance.

The first approach has in principle been followed by the Technology Transfer Board of the Philippines. Following policy guidelines (Resolution No. 188, S'79 dated 3 October 1979) the Board approved royalties in fast food chain agreements at 1 per cent.

The second approach was followed by Suprintendencia de Inversiones Extranjeras of Venezuela. The Registry in Caracas recommended a royalty rate of 3 per cent of net sales (against 5 per cent requested by the franchisor) disaggregated in the following way:

0.5 per cent - use of trademark
1.5 per cent - technical assistance
0.5 per cent - transmission of design, documentation, etc.
0.5 per cent - advisory and consultancy services

3.0 per cent - total fee

Obviously the first approach will result in a substantial decrease in royalty payments. It could be argued however that the example of the Philippine Technology Transfer Board will be very difficult to follow by other countries. As a matter of fact the foreign partner could use a strong argument by pointing out that in the fast food sector the franchise agreement has definitely a broader coverage than a pure trademark licensing agreement.

### 2. Trends in royalty levels in the fast food business

Some indication of an acceptable level of royalty may be drawn from worldwide trends in the fast food business. A comprehensive survey recently carried out in the USA revealed that the royalties ranged from 2 to 5 per cent of gross sales.[8/] The largest international chains who most often extend their operations to developing countries, apply royalty

rates at the level of 4 to 5 per cent. These rates were requested in all contracts surveyed which had been submitted for registration. As has been pointed out earlier, the leading fast food chains seem to accept lower royalty rates in the auxiliary markets in developing countries. Therefore the pressure exerted by the Registry towards decreasing the royalty rate level should bring positive results.

3. The application of the income-sharing concept to the franchise agreement

The income-sharing concept could be used as an analytical tool when evaluating payments in franchise agreements in the fast food industry. This concept, often referred to as the UNIDO method", basically views payments for technology as an "income-sharing device" between the transferor and the transferee. It was originally designed for the evaluation of straight licensing agreements but was further modified in order to cover equity sharing by the transferor.[9/]

For the purpose of demonstration we shall use the project data of one franchise agreement evaluated by SIEX of Venezuela. The foreign partner had requested a royalty rate of 5 per cent of gross sales (equal to 5.05 per cent of net sales). The projected cumulative figures for the period 1982-1986 were the following (in millions of bolivars):

| | |
|---|---|
| net sales | - 195.1 |
| royalties | - 9.8 |
| net profit | - 21.5 |
| cost of production | - 173.6 |

We shall calculate the Licensor Share in Intrinsic Profit (net)

$$LSIP = \frac{\text{royalties}}{\text{net profit + royalties}} = \frac{9.8}{21.5 + 9.8} = \frac{9.8}{31.3} = 31\%$$

As a result of contract evaluation, SIEX recommended a royalty of 3 per cent of net sales. Consequently:

| | |
|---|---|
| net sales | - 195.1 |
| royalties | - 5.8 |
| net profit | - 25.5 |
| cost of production | - 169.6 |

Thus

$$LSIP = \frac{5.8}{25.5 + 5.8} = 19\%$$

The profit-sharing concept should be predominantly used for comparative analysis by relating the LSIP coefficients in the fast food sector to those calculated in other industries as well as for international comparisons.

4. Basis for calculating royalties

Traditionally royalties in the fast food business are expressed as a percentage of gross sales. In principle technology transfer Registries prefer net sales as a basis for calculating royalties but in the fast food industry the difference between gross and net sales is practically insignificant. The term "gross sales" excludes sales taxes, whereas discounts and price reductions are negligible because food and beverages are served exclusively on restaurant premises.

However, the question of defining gross sales calls for special attention on the part of the Registry. This is because it sometimes includes the sale of alcoholic beverages (beer) as well as cigarettes. The laws of several countries do not allow for the collection of fees from sales of cigarettes and/or alcoholic beverages, and in one case the franchisors attempted to protect their interests by introducing an adjustment formula as follows:

> "If the franchisor is not permitted by law to receive a percentage of the sale of alcoholic drinks or beer, the monthly royalties shall be adjusted in an appropriate manner to reflect a percentage of the gross sales of food and non-alcoholic beverages, instead of gross sales".

It is recommended that Registries exclude such provisions from contracts submitted for registration as this violates the already mentioned regulations. As a rule there are strong arguments for disregarding the sale of alcohol and cigarettes when calculating royalties. It could be argued that the serving of beer and the selling of cigarettes does not belong to the concept of chain restaurants which are predominantly patronized by youth and children and consequently do not require chain-specific technology and skills.

D. Recommended levels for initial and basic franchise fees

The foregoing analysis leads to the conclusion that the upper and lower fee levels applied in the fast food chain industry were well defined. The initial fees range from US$5,000 to US$30,000 and franchise royalties from 1 to 5 per cent of gross sales. Obviously both the franchisor as well as the Registry should strive at achieving lower levels, i.e. US$5,000 for the initial fee and a royalty rate equal to 2 per cent of gross sales. Taking into consideration the prevailing conditions in a given country as well as the bargaining strength of both partners, the Registry should adopt a flexible attitude and if necessary approve middle-range fee levels. With respect to the royalty rate, the 1 per cent level may be extremely difficult to achieve and therefore the 3 per cent level could be regarded as a more realistic goal.

E. The level of fees in franchise agreements involving foreign equity participation

As has already been pointed out in Chapter I the franchise contracts are quite often accompanied by the sharing of the franchisor in the franchisee's equity. Under such circumstances the Registry should apply a different approach compared to the straight-forward franchise agreement, with due consideration of course to local laws regulating direct foreign investment.

As a matter of principle the payment of fees and royalties on franchise agreements concluded with wholly or majority owned subsidiaries should not be approved, even though a formal agreement granting property rights to the subsidiary company might be accepted. In the case of minority equity control, the whole problem becomes somewhat complicated. In this respect we shall refer again to the experience of SIEX. In the above quoted example the foreign partner wished to retain control of 49 per cent equity while demanding a royalty rate of 5 per cent on gross sales. As a result of contract evaluation, SIEX recommended the following option:

- 19 per cent of equity control (i.e. maximum control for companies classified in Venezuela as national) and 3 per cent on net sales;

- 49 per cent of equity control and a nominal royalty of 1 per cent on net sales.

In order to compare existing alternatives we shall use the modified profit-sharing concept in the joint venture. The respective expression of LSIP reads as follows:

$$LSIP_{JV} = \frac{\text{royalty + percentage of foreign equity + profit after tax}}{\text{profit after tax plus royalty}}$$

While again taking as an example the project data quoted above, we arrived at the following results.

1. Franchisors request $LSIP_{JV} = \dfrac{9.8 + 49 \text{ per cent} \times 21.5}{21.5 + 9.8}$

$$= \frac{20.3}{31.3} = 65 \text{ per cent}$$

2. Registry recommendation (a) $LSIP_{JV} = \dfrac{5.8 + 19 \text{ per cent} \times 25.5}{25.5 + 5.8}$

$$= \frac{10.6}{31.3} = 34 \text{ per cent}$$

$$(b) \qquad LSIP_{JV} = \frac{2.0 + 49 \text{ per cent} \times 29.3}{29.3 + 2.0}$$

$$= \frac{16.4}{31.3} = 52 \text{ per cent}$$

The results of the calculation of $LSIP_{JV}$ seem to suggest that the first proposal made by the Registry is preferable to the second one, bearing in mind however that additional taxes are usually imposed upon profits remitted abroad, and from the country's perspective, the final differences may be insignificant.

## F. Remuneration for technical services

### 1. Remuneration for training services

As already mentioned in Chapter II the provisions relating to training lacked precision. This applies to payment conditions as well. During contract evaluation, the Registry may distinguish between basic and additional training. The former should be seen as the obligation of the franchisor already covered by the payment of an initial fee. Several contracts stipulated that during the pre-opening period one or two trainees from each outlet would be trained abroad free of charge, the franchisor covering living expenses as well. However the cost of additional training had to be covered by the franchisee. The above conditions for training seem acceptable and may be recommended by a Registry.

The majority of contracts surveyed relied on the principle of cost reimbursement with respect to training. Since this applied mostly to training conducted abroad at the franchisor's training centre, the definition of cost should be further clarified. The cost formula could be accepted by the Registry providing it includes travel and living expenses only for the participants, without any charges for running the educational facility. Consequently the Registry could insist on an adequate definition of the cost formula. It is also recommended that the cost for obligatory training should be covered in full by the franchisor.

### 2. Remuneration for services rendered to local suppliers

In Chapter III we pointed out the need to assist local suppliers of raw materials, ingredients, etc. in order to decrease the overall import dependency of the chain restaurant industry in developing countries. The import substitution programme may be further stimulated by additional financial incentives to the franchisor for services rendered to local suppliers. An example of such an arrangement was found in one contract:

> "A bonus of X per cent on gross sales shall be payable upon proof that the franchisor assisted local raw

material suppliers and business in improving the quality of their products, or searching for export markets for the generation of net foreign exchange earnings from export activity".

It is however suggested that an eventual bonus for the services rendered to local suppliers be directly linked to the positive results of such activities, i.e., it should be expressed as a percentage of the value of local purchases substituting imports.

3. Remuneration for other technical services

Following the recommendation made in Chapter II the Registry could consider various technical services rendered in the course of restaurant operations as an inherent aspect of chain activities, the cost of which is covered by the initial and basic franchise fees. Therefore additional payments for technical services should be eliminated as much as possible. If this cannot be avoided the Registry may accept the reimbursement of cost for rendering certain services specifically defined in the contract.

G. Contribution to the advertising programme

The overwhelming majority of contracts surveyed contained the requirement that the franchisee spend a minimum amount expressed as a percentage of gross sales on advertising (usually between 3 and 5 per cent). The idea behind this requirement is that the fast food industry has always been characterized by fierce advertising campaigns and the relatively high advertising expenditures are an inherent aspect of the functioning of that industry. On the other hand one can argue that the above quoted provision has a restrictive character as it allows excessive control of the franchisee's operations. The latter question could be only resolved by taking into consideration the local laws and regulations. The level of advertising expenditures should also be considered against conditions locally prevailing. If the required advertising budget by far exceeds the average local trends in that field then the Registry may recommend decreasing the obligatory advertising fund.

The above comments refer mainly to situations where the franchisee is required to spend a given amount on advertising. Alternatively the contract may stipulate that the franchisee should contribute to the worldwide or regional advertising programme administered by the franchisor. In practical terms this might be interpreted as an increase of royalty, although the franchisee is often authorized to draw from this fund to cover certain advertising expenses.

It is recommended that the financial contributions to global or regional advertising programmes should not be accepted as world wide advertising campaigns are the sole responsibility of the franchisor.

H. Payment of a deposit

In some contracts provisions were found imposing the franchisee to pay a deposit prior to signing the agreement. Such a typical clause would read as follows:

> "As a deposit for the payment of the foregoing initial fees, the franchisee shall pay upon execution hereof, and the franchisor hereby acknowledges receipt of, the sum of X. Such deposit shall be used and applied against the payment of the above mentioned initial franchise fees until the deposit is completely used. In the event the franchisee does not meet the development requirement as set forth in Article 2, any amount of such deposit payment not credited to initial fees hereunder will be retained by the franchisor as liquidated damages".

As a rule clauses imposing payment of a deposit should be regarded as one-sided and to some extent restrictive. It is therefore suggested that these should not be sanctioned by Registries. Payment of deposits usually take place at a very difficult period for the franchisee who is usually a small or middle-sized enterpreneur.

V. DURATION AND EXTENSION OF FRANCHISE AGREEMENTS IN THE FAST FOOD SECTOR

A. Explanatory remarks

Based on the accumulated experience gained in the process of evaluating and registering technology transfer agreements in the manufacturing industry, many Registries introduced universal rules

with respect to the acceptable length of contract duration. Such rules were sometimes reflected in the existing local laws and regulations. Usually the Registries agree to a contract duration not exceeding five years, subject to further extension under clearly defined conditions. It has been noted that the above mentioned rules are universally applied to contracts in the services sector as well.

However, it could be argued that the conditions prevailing in the fast food business call for a different approach to that adopted for contract durations in the manufacturing industry. This is because the effective assimilation of technology and skills for chain restaurant operations do not call for the ending of a contractual relationship with the foreign partner. On the contrary, the success of the local franchisee represents the major argument for continuing such relationships. In the manufacturing sector the Registries recommend a shortening of the contract duration in order to eliminate unnecessary payments beyond the period required for the effective assimilation of technology. With respect to the fast food sector however, the objectives for defining the rules for contract duration and extension are somewhat different:

- to terminate an agreement which has not brought expected results at the micro level;

- to terminate an agreement which brought negative socio-cultural effects to the development objectives of a given country;

- to review the progress achieved in some crucial areas (e.g. training, import-substitution programmes, etc.);

- to revise principal contract conditions;

- to amend a contract in order to implement new policy objectives.

B. Results of the empirical survey

The period stipulated in the contracts surveyed ranged from five to twenty years. In the case of a five-year duration the automatic extension was foreseen for a further one or two consecutive five-year period.

C. Recommendations with respect to contract duration and extension

In view of the arguments presented it is recommended that Registries follow a more flexible approach compared to the licensing agreements in the manufacturing sector. Since the initial five-year period may be too short for the assimilation of technology and the acquiring of experience for a successful operation of a fast food restaurant, an initial period of ten years may be justified. As for extensions, the automatic extension formula should be avoided. Alternatively, the Registry may indicate areas to be reviewed towards the end of the initial term an affect a final decision on contract extension.

## Notes

1/ For the sake of simplicity, the word "Registry" is used throughout the text when referring to these institutions.

2/ This recommendation was made by the Seventh Meeting of Heads of Technology Transfer Registries, New Delhi, India, 7-10 December 1982.

3/ See J. Cieslik, Contractual Arrangements for the Transfer of Technology in the Fast Food Sector (UNIDO, ID/WG.405/2, Vienna, 1983).

4/ See Franchise Investment Law and Related Rules, State of California, Department of Corporations, Commissioner of Corporations, January 1971, p. 5

5/ J. L. Fels, Investigate before Investing. Guidance for Propspective Franchises, International Franchise Association, Washington, 1971, p. 2

6/ One has therefore to be very careful with the names of the contractual arrangements and the definitions of privileges granted. Quite often a typical franchise is called a "license agreement". As for the rights granted, three alternative formulations can be found covering in principle the same privileges: (1) granting of a license; (2) granting of a franchise; and (3) granting of license and franchise.

7/ See M. Mendelsohn, The Guide to Franchising, Pergamon Press, Oxford, U. K. 1982, p. 122

8/ See C. Vaughn, Franchising. Its Nature, Scope, Advantages, and Development, Lexington Books, Lexington, Mass., p. 224

9/ The most up-to-date version of the profit-sharing concept can be found in V. R. S. Arni, Evaluation of Technology Payments, ID/WG.429/5, UNIDO, Vienna, 1984